

ICPS newsletter

Decline in GDP Could Slow Down

What was the reason for the reduction of GDP decline rate in April? Could such positive dynamics hold for the whole period of this year? What are the factors that could destabilize the economic situation in 1999?

These issues were covered by Deputy Minister of Economy Ihor Shumylo in his report during the macroeconomic seminar at the International Centre for Policy Studies. In this issue of "ICPS Newsletter" we present the key aspects of the deputy minister's speech.

Good News in April

The real decline in GDP for January-April 1999 was 4.1%, whereas for the first quarter this indicator was 4.8%. What does this change mean? We could talk about it as the radical change of a tendency, or a statistical mistake, or even just a "push" that would never appear again.

Let us consider other macroeconomic indicators. First, let us look at inflation. The inflation rate in April was 2.3%. This figure is the result of the increase in prices for electric energy and gas consumed by the households and consequent increase in municipal service tariffs. 25 regions and one city have already approved the decision for increasing tariffs for municipal services from May 1.

Second, cash revenues of the State Budget. In April, the actual level of cash revenues, for the first time, had exceeded the minimum level that was agreed with the IMF. This level was about Hr 1 billion, with Hr 1.2 billion actually being received.

Third, the exchange rate. During April, the exchange rate was stable both at the inter-bank market (holding at a rate of Hr 3.93/USD) and the Moscow market (the exchange rate was unchanged for several weeks and reached a level of Hr 3.975/USD).

Fourth, monetary indicators. If during the first quarter an essential decline both in the monetary base and broad money was

observed, then in April the monetary base went up by more than 7% and broad money by almost 5%. Surprisingly, households deposits by physical entities in national currency went up by slightly more than 4%.

Did Radical Change Occur in April: Pros and Cons

Arguments that the negative dynamics of economic development would radically change before the end of 1999 are supported by several points.

The regulation draft that was prepared several weeks ago and passed to the Presidential Administration, list of decrees being prepared now, and final editing of the letter concerning the Memorandum of Economic Policies obviously manifest that administrative interruption in economic activity would be after all reduced.

During the last six weeks, daily trade volumes at the foreign exchange market reached \$30-40 million. The National Bank is buying foreign exchange almost every day. This fact allows one to expect with a high degree of confidence that the average annual exchange rate in 1999 will keep to the level Hr 4/USD, and by the end of the year the hryvnia exchange rate would not exceed the level of HR 4.2-4.3/USD. Stabilization will be fostered by essential additional support (above the preliminary defined volumes) from the IMF in the

This Week

Strategy for improving the budget process. On Saturday May 29, the International Centre for Policy Studies, within the framework of the Centres of Policy Excellence: Budget Policy project, will hold a quarterly seminar on the issue "Designing an Effective Budget Process for Ukraine".

The results of the workshop will be a strategy for the budget process that identifies:

- core changes needed in Ukraine's budget process;
- barriers to achieving change in Ukraine's budget process;
- approaches for breaking the barriers to needed changes.

Three presentations have been planned:

- "Linking Objectives of Budget Policy and Expenditure Programs" (Stephen Leeds, U.S. Treasury Advisor for the Ministry of Finance of Ukraine);
- "Problems with Ukraine's Budget Process and Potential Solutions (Anatoliy Maxiuta, Head of the Main Budget Department of the Ministry of Finance of Ukraine);
- "Approaches to Reforming the Budget Process in Lithuania" (Rimantas Veckis, Head of the Main Budget Department of the Ministry of Finance of Lithuania).

During group work the following issues will be discussed:

1. What are the critical changes needed in Ukraine's budget process?
2. Have these recommendations been provided to decision-makers in the past?
3. What are the barriers to change? Classifying barriers as political, economic, capacity, institutional and other.
4. What can we do to increase the likelihood of our proposals being accepted?

Concerning invitations for this seminar, please contact Larysa Romanenko.

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Monthly Real GDP Dynamics in 1999

Month	Month of 1999 to the corresponding month of 1998	Cumulative from the beginning of 1999 to the corresponding period of 1998
January	-3,3	-3,3
February	-5,0	-4,2
March	-5,7	-4,8
April	-2,2	-4,1

amount of \$300 million. Due to these factors, obviously the credit activity of the National Bank would increase, and consequently, the volumes of the economy's crediting as well as monetary emission volume could appear higher than preliminarily defined at the level of 9%.

Inflation is under control. The increase in tariffs for municipal services, reaching 100% of the cost value of services, will result in 6-7% inflation. But there is a threat that the inflation rate will be above the 19% that we have predicted. We consider it important to define this figure as a border that sets a limit for the inflation rate. And all the measures of economic policy, particularly monetary and budget, have to provide stability of prices after their administrative increase.

Such macroeconomic indicators (inflation rate, exchange rate, and increase of monetary support of the economy) have to provide favorable conditions to stop the economy's decline. If we consider the traditional quarterly GDP dynamics, we find that the total annual level of -1% is attainable. Of course, this is the most optimistic scenario, as all forecasting a decline of at least 3%. We assume that the optimistic scenario is possible only if all activities foreseen by EFF programs and the World Bank projects are completed.

What risks exist? The first risk is associated with the non-fulfillment of joint programs with international creditors. Failure to perform the terms of agreement will not only suspend financing, but also considerably worsen the economic situation.

The second threat is even more important and deals with the situation that neither population nor businessmen could have believed in radical and consistent conduction of a reform, hence, all attempts to revive the demand will result in destabilization of inflation and the exchange rate. Do we have large enough reserves to defend the currency rate? We should honestly say "no". That is why it is of major importance to realize the announced policy consistently.

The third threat is the economic development of countries that are major trade partners. From one side we see some positive changes, particularly in Eastern Asia, from the other side, we could evaluate the development of events in Russia and their possible influence on Ukraine. For the first quarter, export decline came to 21% and imports to 27%, the trade deficit decreased from \$0.9 billion to \$0.43 billion, hence the negative balance decreased 2 times. Export to NIS countries fell by more than 40%, and import shrank slightly more than by 20% (as demand for energy suppliers is inelastic). Thus, the development of events in Russia, accounting for their possible influence on Ukraine, is a very weighty factor and requires further evaluation.

Seminar "April 1999: Has the Negative Tendency of Development Radically Changed?" International Centre for Policy Studies, May 18, 1999.

Anomalies of the Socialist Growth

In the fourth issue of the monthly journal "Policy Studies" the International Centre for Policy Studies has published selected sections from the work of leading Russian economist Egor Gaidar "Anomalies of Economic Growth". The research contains an interesting and unusual depiction of the mechanism of socialist growth and provides an evaluation of welfare steadiness levels reached by the Soviet Union in 1970 - 80. To the opinion of Gaidar, production structures created in that period cannot exist without an external resource supply, that has to be restructured as soon as possible. We present the main conclusions of the published work.

1. Removing market mechanisms and substituting them with an integrated hierarchy allows for extending possibilities of maneuvering the accumulation rate rapidly, increasing the dimensions of resource redistribution from traditional agriculture, and obtaining a high growth rate of the share in industry and industrial production volume.
2. The crisis of this growth model starts after basic resources of traditional agriculture are drained. This is when all of its inner limitations become apparent – high power-consumption, low borrowing power of the process industry's production, absence of structural shift mechanisms within the framework of the economy's modern sector, low effectiveness of investments. The totality of these factors makes for a trend towards a rapid fall in the capital productivity ratio and in the economic growth rate.
3. Greater rigidity of resource limitations incites countries with poor resources to leave the framework of the socialist growth model during the early stages of development, when they still possess sizeable reserves of cheap man power with zero ultimate output in the traditional sector. Countries rich in resources have the opportunity to respond to the crisis of early socialist industrialization with increasing mineral export and agricultural import.
4. Leaving socialism with preserving economic growth is possible only at early stages of industrialization, when the potential of the traditional peasant sector is retained, on whose base market economy (parallel to that of the state) will grow (as it was in China). After basic reserves of the traditional sector are exhausted, any strategy aiming toward renewing market growth demands serious structural reorganization of the modern industrial sector and is inevitably followed by a fall in production volume.

5. Economic growth in the USSR and countries of EMAC in 1970-1980 was an attempt to cross the borders of inner limitations of the socialist growth model, and it bore an unstable nature. It paved the way for a sharp crisis and break-up of the system. The most important factors that caused instability of this system were bound up with the basic characteristics of a socialist economy, its low productivity, inability to produce competitive export from the processing industry, ensuring radical decrease in power-consumption production.

6. Failure of the socialist model caused a drastic fall in production and consumption in former socialist countries to a level similar to that of the early 1970's.

7. Restoration of market regulators caused tendencies to approaching post-socialist economies' structural characteristics to indexes peculiar to market economies of the same development level. Though even nowadays post-socialist economies differ in the great volume of resource redistribution through the state budget. High power-consumption of production and less share of the processing industry's export in GDP are peculiar to them, - it will take years and years and violent efforts to change the situation.

The conducted analysis allows us to understand the reasons of failure in attempts to keep production structures during oil growth in 1970-1980. These structures themselves were inwardly unstable and unbalanced; they couldn't exist without outer resource replenishment. Not preserving existing links and production structures, but rapidly reorganizing them to adapt to fundamentally different conditions of the post-socialist world is the most important prerequisite for stabilizing and renewing economic growth.

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